

2002

Amended
F



Year	Deaths
2001	4.8
2002	6.1

2002 was a challenging year for SBC and the telecommunications industry. Every company was tested. The economic downturn, regulatory uncertainty, and growing competition and substitution — especially in the local service market — continued to take their toll.

Despite these difficulties, we remain optimistic about our future. We operate in a great industry, one that is essential to almost every person and business in this country. We are a part of one of the most innovative industries in the world — one that has changed the way people work and live for the better and will continue to do so. We operate in great markets with great services, and we are providing excellent opportunities for growth after we have passed through these challenging times.

And we will get through this. In late February, the Federal Communications Commission (FCC) issued its Triennial Review ruling. While the ruling appears to bring fairer and more equitable rules to the broadband business, we regret that the FCC missed an important opportunity to reform the wholesale rules that now hinder investment in the nation's telecommunications infrastructure and threaten healthy competition. We will continue our efforts in the judicial, regulatory and legislative arenas to promote healthy, sustainable competition by encouraging all competitors to invest in their own facilities.

SBC begins the year operating under a single, national brand, replacing the regional brands of the past (except for SBC SNET). As we evolved into one of the world's largest and most technologically advanced telecommunications companies, it made sense for us to take this step. Our competitors market under national brands, and our customer segments — especially our enterprise and data businesses — are more national than they are regional. This is the most effective, cost-efficient way to position the company in all markets.

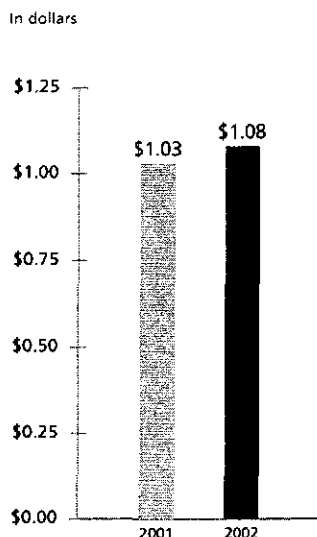
A LOOK AT 2002

SBC faced a difficult environment last year. We acted swiftly and decisively to minimize the impact of these conditions and to solidify SBC's position as one of the strongest, most financially sound companies in the industry.

We Focused on Growth Drivers

We looked to increase revenues in our major growth drivers — long distance, DSL, data and wireless. We also worked to develop a regulatory framework that would allow us to grow. The industry needs a pro-growth and pro-investment regulatory environment that nurtures sustainable competition from companies that invest in their own networks. The rules needed to be reformed in certain key areas — such as in broadband and in the wholesale market — to achieve this goal.

ANNUAL DIVIDENDS PER COMMON SHARE (DECLARED)



We Took Steps to Strengthen Our Balance Sheet

Despite pressure from declining revenues in 2002, SBC strengthened the long-term viability of the company. We have one of the strongest balance sheets in the telecom industry and worked to make it even stronger by taking the following steps:

- Reduced total debt from \$26 billion to \$22 billion.
- Reduced reliance on commercial paper from \$6.0 billion, down to \$1.1 billion.
- Sold assets, including our interest in Bell Canada, which in total generated \$4.3 billion in cash proceeds.
- Generated \$15.2 billion in cash from operations, an increase over 2001.

We Returned Value Directly to Shareowners

SBC increased its dividend to shareowners by 5.4 percent. This is the 18th consecutive year that we have increased our dividend, a record unmatched by any major telecom company and by few companies at all. During the year, we also repurchased 44.2 million shares of SBC common stock.

We Cut Costs

Since growth opportunities were limited, we attacked costs while protecting customer service and the integrity and vibrancy of the network. We initiated an extensive cost-reduction program that helped reduce cash operating expenses by nearly \$400 million during the year. We also reduced our capital investment by \$4.4 billion from the year before. Finally, as a last resort, we reduced the number of employees (and contractors) by 20,000 from 2001. Much of this was achieved through attrition and voluntary separation; however, we did unfortunately have to lay off employees during the year.

These actions helped us deal with the challenges we faced but they were not enough to overcome the loss of more than 4 million retail access lines to competitors last year. The financial effect can be seen in the decline of revenues and net income. We are not happy with this type of financial performance, regardless of the reasons. We will continue to take necessary steps in order to return the company to growth.

FOCUS ON GROWTH STRATEGY

In each of our strategic growth areas, we ended the year better-positioned than we began, setting the stage for continued expansion as the economy and regulatory framework improve.

Long Distance

We increased our long-distance customer base by 25 percent to more than 6 million customers. InterLATA long-distance revenues increased 35 percent. Regulatory delays slowed our growth, but by the end of the year, the situation improved dramatically. In California, we began offering long distance on Dec. 30, doubling the long-distance market opportunity for SBC. California's \$10 billion voice and data communications long-distance market is the largest in the country. We also achieved state regulatory approval in Nevada and, in January 2003, in Michigan. We hope to have FCC approval to begin offering service in those states in April. In the remaining SBC

states — Illinois, Indiana, Ohio and Wisconsin — we continue to work toward receiving regulatory approval. We hope to be able to offer long distance to our entire service area as early this year as possible.

DSL

SBC remains the nation's leading provider of DSL services. We finished the year with 2.2 million DSL subscribers — a 65 percent increase over 2001 — surpassing our target of 2 million subscribers for the year. Growth has been steady, with quarterly sequential improvement throughout the year. Growth opportunities continue to increase as we can now offer DSL to more than 66 percent of total customer locations, up 8.2 percent from 2001. We also have made our broadband offering more attractive by adding personalized speed and price options for our customers. Through an alliance with Yahoo!, we created an Internet portal that Forrester Research called superior to that of our competitors.

Data

The rugged economy impacted our data revenues, but the market continues to be a significant growth opportunity for the company, especially as we win long-distance freedom. SBC introduced an enhanced, standardized portfolio of national data transport solutions, furthering our strategy to deliver to business customers a new class of integrated data and IP (Internet Protocol) networking services. SBC's network already includes 300 points of contact outside our 13-state territory with additional IP router structure being deployed as long-distance approval is granted. Additionally, SBC expects completion of the national expansion phase of its data and IP network backbones by mid-2003. This will allow us to provide a full range of data and IP services to customers in 50 of the nation's largest cities.

Wireless

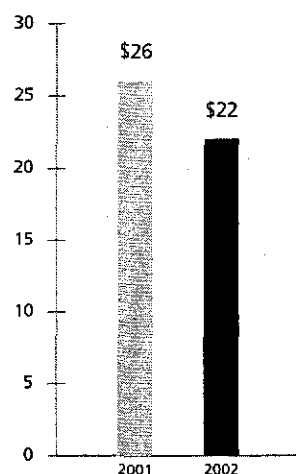
The customer base for SBC's wireless joint venture, Cingular Wireless, grew to 21.9 million. During 2002, Cingular expanded into the New York City metropolitan area, putting the company in the top 10 U.S. markets. Cingular also continues the build-out of its GSM overlay network to support advanced network capabilities. Cingular has now upgraded 50 percent of its network and expects to have 90 percent data-capability coverage by the end of 2003; full completion of the data network is expected in 2004. Several wireless data services have already been launched, and usage continues to grow. Cingular had more than 5.5 million active data customers at the end of 2002.

Marketing Initiatives

We continue to have success with our packaging of services. These marketing innovations have helped revenue growth, customer retention and customer winback efforts. We introduced our most comprehensive package, *SBC Total Connections*, which bundles all SBC services in one package at one reduced rate. Other packages, including those tailored to small-business customers, also were introduced. Consumer packages grew 10 percent. Business packages grew 4.5 percent. These bundles would not be popular if we did not offer outstanding customer service. We have continued to make investments in order to improve service quality. In some states, service is at the highest levels in nearly two decades.

TOTAL DEBT

Dollars in billions



REGULATORY ENVIRONMENT

No other area influenced the financial performance of the company more than the regulatory environment. This was most evident in a policy that allowed competing companies to purchase SBC local service at below-cost wholesale rates, then resell it to their customers. Known as the "unbundled network elements platform" or UNE-P, it is a policy that ultimately required SBC and other Bell companies to, in effect, subsidize our competitors, including some of the biggest companies in our industry.

Unfortunately, the 3-2 ruling by the FCC keeps these subsidies in place. This is disappointing because rather than reform the rules to provide an economic stimulus to the entire industry, the FCC has chosen to continue guaranteeing profits to competing companies without requiring them to invest anything in the local-phone networks. The new rules governing local competition appear to disregard previous orders by the U.S. Supreme Court and the U.S. Court of Appeals. This is a loss for American consumers, telecom employees and advocates of real reform. This order will be appealed. At the same time, we will continue our work on both the state and federal level to bring rules that are more fair, which our industry desperately needs and that our customers and investors deserve.

LOOKING AHEAD

We enter 2003 knowing that the challenges we faced last year have not been resolved. Without a doubt, 2003 will be as challenging as 2002, especially on the revenue side.

But there are some positives. The FCC action on broadband appears to bring fairer regulatory policies in that part of our business. This should create greater growth opportunities for us in DSL and future broadband services. We are also confident that we will achieve long-distance approval in all of our states as early as possible in 2003, providing a stimulus to our packaging and data sales. More than a third of the U.S. population lives in our traditional service areas, and nearly half of the Fortune 500 companies have headquarters in our region. As our long-distance and data networks grow, so will our opportunities to provide a full range of services to these customers.

We continue to manage our business prudently. Our top priority continues to be delivering the highest-quality customer service, while focusing on our goals of growth and financial strength. We remain cautious about our short-term earnings outlook primarily due to the weak economy, increasing competition and substitution, regulatory uncertainty and the impact of greater pension and post-retirement health-care costs. We will continue to exercise rigorous financial discipline in our operations with a sharpened focus on our growth drivers — long distance, DSL, data and wireless.

The past year was a trying one for our company and our industry. I am very proud to lead an SBC employee team that answered these challenges with decisive action and worked to overcome obstacles with a professionalism that investors have come to expect. We have earned a strong position in our industry, even in these turbulent times, and I am confident of our potential for growth. You can expect your SBC employee team to work each day to increase the value of our company. That is our commitment to you ... and a source of pride to us.

Sincerely,

Edward E. Whitacre Jr.

Edward E. Whitacre Jr.
Chairman and Chief Executive Officer
February 20, 2003

SELECTED FINANCIAL AND OPERATING DATA

Dollars in millions except per share amounts

At December 31 or for the year ended:	2002	2001	2000	1999	1998
Financial Data¹					
Operating revenues	\$43,138	\$45,908	\$51,374	\$49,531	\$46,241
Operating expenses	\$34,515	\$35,400	\$40,904	\$37,933	\$35,018
Operating income	\$ 8,623	\$10,508	\$10,470	\$11,598	\$11,223
Interest expense	\$ 1,382	\$ 1,599	\$ 1,592	\$ 1,430	\$ 1,605
Equity in net income of affiliates	\$ 1,921	\$ 1,595	\$ 897	\$ 912	\$ 613
Other income (expense) – net	\$ 734	\$ (208)	\$ 2,562	\$ (354)	\$ 1,702
Income taxes	\$ 2,984	\$ 3,952	\$ 4,816	\$ 4,280	\$ 4,380
Income before extraordinary items and cumulative effect of accounting change	\$ 7,473	\$ 7,026	\$ 7,800	\$ 6,573	\$ 7,735
Net income ²	\$ 5,653	\$ 7,008	\$ 7,800	\$ 8,159	\$ 7,690
Earnings per common share:					
Income before extraordinary items and cumulative effect of accounting change	\$ 2.24	\$ 2.09	\$ 2.30	\$ 1.93	\$ 2.27
Net income ²	\$ 1.70	\$ 2.08	\$ 2.30	\$ 2.39	\$ 2.26
Earnings per common share – assuming dilution:					
Income before extraordinary items and cumulative effect of accounting change	\$ 2.23	\$ 2.07	\$ 2.27	\$ 1.90	\$ 2.24
Net income ²	\$ 1.69	\$ 2.07	\$ 2.27	\$ 2.36	\$ 2.23
Total assets	\$95,057	\$96,322	\$98,651	\$83,215	\$74,966
Long-term debt	\$18,536	\$17,133	\$15,492	\$17,475	\$17,170
Construction and capital expenditures	\$ 6,808	\$11,189	\$13,124	\$10,304	\$ 8,882
Dividends declared per common share ³	\$ 1.08	\$ 1.025	\$ 1.015	\$ 0.975	\$ 0.935
Book value per common share	\$ 10.01	\$ 9.82	\$ 9.09	\$ 7.87	\$ 6.69
Ratio of earnings to fixed charges	6.36	5.95	6.81	6.52	6.79
Debt ratio	39.9%	44.3%	45.0%	42.9%	47.3%
Weighted average common shares outstanding (000,000)	3,330	3,366	3,392	3,409	3,406
Weighted average common shares outstanding with dilution (000,000)	3,348	3,396	3,433	3,458	3,450
End of period common shares outstanding (000,000)	3,318	3,354	3,386	3,395	3,406
Operating Data					
Network access lines in service (000)	57,083	59,532	61,250	60,697	58,980
Access minutes of use (000,000)	269,440	283,164	281,581	264,010	247,597
Wireless customers (000) – Cingular/SBC ⁴	21,925	21,596	19,681	11,151	8,686
Number of employees	175,980	193,420	220,090	204,530	200,380

¹Amounts in the above table have been prepared in accordance with accounting principles generally accepted in the United States. The 2001 and 2000 results have been restated for our adoption of the fair value recognition provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (FAS 123) as amended by Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure" (FAS 148). This adoption reduced our 2002 net income \$261, or \$0.08 per share assuming dilution, 2001 net income \$234, or \$0.06 per share assuming dilution, and 2000 net income \$167, or \$0.05 per share assuming dilution. The years 1999 and 1998 were not restated for our adoption of FAS 148, as allowed by the standard; however, had our results for 1999 and 1998 been restated, net income for 1999 would have been reduced by \$189, or \$0.05 per share assuming dilution, and 1998 net income would have been reduced by \$153, or \$0.04 per share assuming dilution.

²Amounts include the following extraordinary items and cumulative effect of accounting change: 2002, charges related to the January 1, 2002 adoption of Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets"; 2001, loss related to the early extinguishment of our corporation-obligated mandatorily redeemable preferred securities of subsidiary trusts; 1999, gain on the sale of overlapping cellular properties and change in directory accounting at Ameritech; 1998, early retirement of debt and change in directory accounting at SNET.

³Dividends declared by SBC's Board of Directors; these amounts do not include dividends declared and paid by Ameritech in 1999 or 1998 or SNET in 1998 prior to their respective mergers.

⁴All periods exclude customers from the overlapping Ameritech wireless properties sold in 1999. Beginning in 2000, the number presented is the total customers served by Cingular Wireless, in which we own a 60% equity interest.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Dollars in millions except per share amounts

Throughout this document, SBC Communications Inc. is referred to as "we" or "SBC". We are a holding company whose subsidiaries and affiliates operate in the communications services industry. Our subsidiaries and affiliates provide wireline and wireless telecommunications services and equipment and directory advertising services both domestically and worldwide.

You should read this discussion in conjunction with the consolidated financial statements and the accompanying notes. A reference to a Note in this section refers to the accompanying Notes to the Consolidated Financial Statements.

RESULTS OF OPERATIONS

Consolidated Results

Our financial results are summarized in the table below. We then discuss factors affecting our overall results for the past three years. These factors are discussed in more detail in our segment results. We also discuss our expected revenue and expense trends for 2003 in the "Operating Environment and Trends of the Business" section.

	2002	2001	2000	Percent Change	
				2002 vs. 2001	2001 vs. 2000
Operating revenues	\$43,138	\$45,908	\$51,374	(6.0)%	(10.6)%
Operating expenses	34,515	35,400	40,904	(2.5)	(13.5)
Operating income	8,623	10,508	10,470	(17.9)	0.4
Income before income taxes	10,457	10,978	12,616	(4.7)	(13.0)
Income before extraordinary item and cumulative effect of accounting change	7,473	7,026	7,800	6.4	(9.9)
Extraordinary item ¹	—	(18)	—	—	—
Cumulative effect of accounting change ²	(1,820)	—	—	—	—
Net income	5,653	7,008	7,800	(19.3)	(10.2)
Diluted earnings per share	1.69	2.07	2.27	(18.4)	(8.8)

¹2001 includes an extraordinary loss related to the early redemption of \$1,000 of our corporation-obligated mandatorily redeemable preferred securities of subsidiary trusts (TOPRS).

²2002 includes a cumulative effect of accounting change related to the adoption of a new accounting standard, Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" (FAS 142).

Accounting Changes Prior to January 1, 2002, we accounted for stock options for senior and other management and nonmanagement employees and nonemployee directors using the intrinsic value-based method of accounting as allowed by Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (FAS 123). Using this method meant that in our previously reported results, no compensation cost was recognized in our Consolidated Statements of Income when options were issued with exercise prices at or above market value on the date of issuance. Effective January 1, 2002, we adopted the fair value recognition provisions of FAS 123. Under the retroactive restatement method of adoption we selected in accordance with the provisions of Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure" (FAS 148), our 2001 and 2000 results have been restated to reflect the compensation costs that would have been recognized had the recognition provisions of FAS 123 been applied to all awards granted to employees after January 1, 1995. The adoption of FAS 123 as amended by FAS 148 reduced our

2002 net income \$261, or \$0.08 per share assuming dilution, 2001 net income \$234, or \$0.06 per share assuming dilution, and 2000 net income \$167, or \$0.05 per share assuming dilution. Compensation costs of \$390, \$380 and \$273 for 2002, 2001 and 2000 were charged to operating expense for our stock option plans. As permitted by FAS 148, we did not restate 1999 or 1998. (See Note 12)

The years 2001 and 2000 included amortization expense related to goodwill and Federal Communications Commission (FCC) wireless licenses now owned by Cingular Wireless (Cingular). Beginning in 2002, goodwill and these wireless licenses are no longer being amortized under FAS 142. If FAS 142 had been in effect during 2001 and 2000, operating expenses would have decreased approximately \$209 in 2001, and \$322 in 2000, equity in net income of affiliates would have increased approximately \$354 in 2001, and \$251 in 2000, and net income would have increased approximately \$459, or \$0.13 per share, in 2001, and \$445, or \$0.13 per share, in 2000. See the "Cumulative Effect of Accounting Change" section for a discussion of this accounting change.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Dollars in millions except per share amounts

Overview Our operating income declined in 2002 due primarily to the loss of revenues from retail access lines caused by providing below-cost Unbundled Network Element-Platform (UNE-P) wholesale lines, which was greater than the expense reductions in response to UNE-P, the weak U.S. economy, and increased competition, including technology substitution. Increased expenses in 2002 from special items, discussed under "Segment Results" below, also contributed to the operating income decline in 2002. Our income before income taxes declined in 2002, but the decline was less than the decline in operating income due to increased gains on sales of international investments in 2002. In addition, a lower effective tax rate and a decline in our weighted average common shares outstanding favorably affected our diluted earnings per share in 2002, but we do not expect this trend to continue in 2003.

Our operating income was basically flat in 2001 as compared to 2000. Increased revenues from data communications and long-distance products and services were mostly offset by declines in equipment revenues and increased costs associated with the rollout of these products and services. The contribution of our wireless properties to Cingular, our joint venture with BellSouth Corporation (BellSouth), contributed to the declines in revenues, expenses and operating income in 2001. However, decreased expenses in 2001 from special items, discussed under "Segment Results" below, partially offset the decline in operating income in 2001. Our income before income taxes declined in 2001 due to greater gains on sales of international investments in 2000. In addition, a lower effective tax rate and a decline in our weighted average common shares outstanding favorably affected our diluted earnings per share in 2001.

Operating revenues Our operating revenues decreased \$2,770, or 6.0%, in 2002 and \$5,466, or 10.6%, in 2001. The decline in 2002 was primarily due to a significant increase in retail access lines lost to UNE-P wholesale lines, the weak U.S. economy and increased competition including technology substitution. UNE-P requires us to sell our lines and the end-to-end services provided over those lines to competitors at below cost while still absorbing the costs of deploying, provisioning, maintaining and repairing those lines. See "Regulatory Developments" for further discussion of UNE-P. Operating revenues decreased in 2001 approximately \$5,900, primarily due to the contribution of our wireless properties to Cingular. This contribution changed the way we record Cingular's revenues and expenses in our reported income; we now include Cingular's results under equity in net income of affiliates rather than under operating results (see Note 6). Partially offsetting the decreased revenues in 2001, our wireline segment data revenues increased \$1,450, primarily related to growth in our high-capacity data transport services. In addition, sales of our Ameritech Corporation (Ameritech) security monitoring and cable operations decreased operating revenues approximately \$199 in 2002 and \$480 in 2001.

Operating expenses Our operating expenses decreased \$885, or 2.5%, in 2002 and \$5,504, or 13.5%, in 2001. Operating expenses decreased in 2002 due to the decline in our wireline work force (down over 15,000 employees from 2001) and a lower volume of equipment sales; these largely

occurred in the wireline segment and are discussed in that segment's results. 2002 operating expenses also decreased due to our adoption of FAS 142, whereby we stopped amortizing goodwill, and is discussed in Note 1. Operating expenses decreased in 2001 approximately \$3,800, primarily due to the contribution of our wireless properties to Cingular in the fourth quarter of 2000. In addition, the sale of our Ameritech security monitoring and cable operations reduced operating expenses approximately \$231 in 2002 and \$579 in 2001. As discussed below, the decreases in 2002 were mostly offset by combined charges of \$872 for enhanced pension benefits, lower pension settlement gains, severance costs and real estate costs related to work force-reduction programs as well as by a significant decline in our combined net pension and postretirement benefit.

Combined Net Pension and Postretirement Benefit

Reported operating expenses include our combined net pension and postretirement benefit of \$82, \$436 and \$134 in 2002, 2001 and 2000. A decrease in our combined net pension and postretirement benefit causes our net operating expense to increase. The decrease of approximately \$354 in 2002 was primarily due to a decreased asset base of our employee pension and postretirement benefit plans from net investment losses and previous recognition of pension settlement gains (discussed below) reducing the amount of unrealized gains recognized in 2002. In addition, the reduction in the discount rate used to calculate 2002 service cost and interest cost from 7.75% to 7.5% caused our combined net pension and postretirement benefit to decrease approximately \$58. Also, increased medical and prescription drug claim costs contributed approximately \$80 to the decrease in our combined net benefit in 2002. See Note 10 for further detail of our actuarial estimates of pension and postretirement benefit expense and actuarial assumptions.

Early Retirement Offers Reported operating expenses also include expenses for enhanced pension and postretirement benefits of approximately \$486, \$173 and \$1,175 in 2002, 2001 and 2000 in connection with voluntary enhanced retirement programs offered to certain management and nonmanagement employees as part of work force-reduction programs.

Pension Settlement Gains/Losses Under U.S. generally accepted accounting principles (GAAP), on a plan-by-plan basis, if lump sum benefit payments made to employees upon termination or retirement exceed required thresholds, we recognize a portion of previously unrecognized pension gains or losses attributable to that plan's assets and liabilities. Until 2002, we had an unrecognized net gain, primarily because our actual investment returns exceeded our expected investment returns. During 2002, 2001 and 2000, we made lump sum benefit payments in excess of the GAAP thresholds, resulting in the recognition of net gains, referred to as "pension settlement gains". Due to U.S. securities market conditions, our plans experienced investment losses during 2002 and 2001 resulting in a decline in pension assets. We recognized net pension settlement gains of approximately \$29, \$1,363 and \$2,172 in 2002, 2001 and 2000. Net settlement gains in 2002 include settlement losses during the latter part of the year,

reflecting the continued investment losses sustained by the plan. Settlement gains for 2001 were primarily related to a voluntary enhanced pension and retirement program implemented in October 2000. We anticipate that additional lump sum pension payments will be made in early 2003 in connection with our planned work force-reductions. We cannot estimate at this time whether these payments will result in the recognition of settlement losses in 2003.

Medical Cost Controls As a result of the 2002 decrease in our combined net pension and postretirement benefit and the net cost expected in 2003 discussed below in "Operating Environment and Trends of the Business", we have taken steps to implement additional cost controls. To reduce the increased medical costs mentioned above, in mid-2002, we implemented cost-saving design changes in our management medical and dental plans including increased participant contributions for medical and dental coverage and increased prescription drug co-payments effective beginning in January 2003. These changes reduced our postretirement cost approximately \$96 in 2002. In 2003, we expect cost savings of approximately \$194 from these design changes.

Interest expense decreased \$217, or 13.6%, in 2002 and increased \$7, or 0.4%, in 2001. The 2002 decrease was due to lower composite rates, a lower outstanding balance of commercial paper and the 2001 netting of our payable with our receivables from Cingular. The 2001 increase was due to interest expense on debt issued to redeem the TOPRS, the interest on which was reported as other income (expense) – net; higher commercial paper borrowings that were offset by lower composite rates; and the reversal of an accrual of approximately \$23 related to items resolved by June 2001 Illinois legislation. Prior to the fourth quarter of 2000, we recorded interest expense on notes payable with our wireless properties that was eliminated in the consolidation process. For the operations contributed to Cingular this interest expense was no longer eliminated. This did not have a material impact on our net income as the interest expense was mostly offset when we recorded our share of equity income in Cingular. The interest accrued in 2001 on these payables of approximately \$2,500 increased interest expense in 2001 and subsequently contributed to the decrease in 2002. By agreement, these payables were netted with our notes receivable from Cingular late in the second quarter of 2001.

Interest income decreased \$121, or 17.7%, in 2002 and increased \$403 in 2001. These fluctuations were primarily due to our 2000 contribution of substantially all of our wireless properties to the Cingular joint venture. Prior to the fourth quarter of 2000, we recorded interest income on notes receivable with our wireless properties that was eliminated in the consolidation process. For operations contributed to Cingular, this interest income is no longer eliminated. However, this does not have a material impact on our net income because the interest income is mostly offset when we record our share of equity income in Cingular. The 2001 increase was primarily due to the income accrued from Cingular, prior to our 2001 netting agreement discussed above, which subsequently resulted in the decrease in 2002.

Equity in net income of affiliates increased \$326, or 20.4%, in 2002 and \$698, or 77.8%, in 2001. The 2002 increase was primarily due to income from our international holdings. Income increased approximately \$371 from our proportionate share of the gains at TDC A/S (TDC) and Belgacom S.A. (Belgacom) related to the disposition of their Netherlands wireless operations. Also contributing to the 2002 increase was the prior-year charge of approximately \$197 related to TDC's decision to discontinue nonwireless operations of its Talkline subsidiary and our impairment of goodwill we allocated to Talkline at the time of our initial investment in TDC. This increase was partially offset by a charge of approximately \$58 related to TDC's investments in Poland, Norway and the Czech Republic and a charge of approximately \$101 representing our proportionate share of restructuring costs at Belgacom. Other increases in 2002 of approximately \$126 are discussed in detail in "International Segment Results".

A decline in wireless results, which is discussed in detail in "Wireless Segment Results", partially offset the increased equity in net income of affiliates from our international segment. We account for our 60% economic interest in Cingular under the equity method of accounting and therefore include Cingular's results in our equity in net income of affiliates line item, on a reported basis. (Our accounting is described in more detail in Note 6.) Cingular's results decreased our 2002 equity in net income of affiliates approximately \$270.

The increase in 2001 was primarily due to the contribution of our wireless operations to Cingular, our joint venture with BellSouth. Prior to the fourth-quarter 2000 contribution of substantially all of our wireless properties to Cingular, we included the results from these wireless operations in our consolidated operating results. This change in our accounting method, as a result of the joint venture agreement, increased equity in net income of affiliates approximately \$949 in 2001. The 2001 increase also reflects the absence of approximately \$110 in one-time costs incurred in 2000 for a restructuring of agreements with Prodigy Communications Corporation (Prodigy).

These 2001 increases in equity in net income of affiliates were partially offset by a decrease of approximately \$376 relating to special items in our international operations. This \$376 decrease included: (1) a charge of approximately \$49 to reduce the indirect book value of our investment in Telecom Américas Ltd. (Telecom Américas) to the value indicated by a sales transaction pending at December 31, 2001; (2) a charge of \$197 related to TDC's decision to discontinue nonwireless operations of its Talkline subsidiary and our impairment of goodwill we had previously allocated to Talkline, and (3) approximately \$26 of other 2001 items discussed in "International Segment Results".

Other income (expense) – net increased \$942 in 2002 and decreased \$2,770 in 2001. Results for 2002 include gains of approximately \$603 on the redemption of our interest in Bell Canada Holdings Inc. (Bell Canada) and gains of \$191 on the sale of shares in equity investments, consisting of the sale of shares of Teléfonos de México, S.A. de C.V. (Telmex), América Móvil S.A. de C.V. (América Móvil) and Amdocs

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Dollars in millions except per share amounts

Limited (Amdocs). Also related to the Bell Canada redemption, we recorded dividend income of approximately \$34 from our investment in Bell Canada after our second-quarter 2002 change to the cost method of accounting and income of \$28 related to market adjustments on Canadian dollar foreign-currency contracts. The redemption of our interest in Bell Canada is also discussed in Note 2.

These gains and income in 2002 were partially offset by a charge of approximately \$75 related to the decrease in value of our investment in Williams Communication Group Inc. (Williams) combined with a loss on the sale of our webhosting operations, and a charge of \$12 related to the other-than-temporary declines in the value of cost investments. Additionally, we recorded a charge of approximately \$32 for the reduction in the value of wireless properties that may be received as a settlement of a receivable and expenses of \$10 for dividends paid on preferred securities issued by Ameritech subsidiaries.

Results for 2001 included gains on the full or partial sale of investments of approximately \$476, including our investments in TransAsia Telecommunications, Smith Security, Amdocs shares and other investments. An additional increase of \$120 resulted from a reduction of a valuation allowance on a note receivable related to the sale of SBC Ameritech's SecurityLink business. Also included in 2001 are net gains of approximately \$23 recognized for mark-to-market adjustments on shares of Amdocs, which were granted to executives as deferred compensation. An offsetting deferred compensation expense was recorded in operations and support expense. Also included in 2001 was approximately \$32, which represents consideration for modifications to our agreement with SpectraSite Communications Inc. (SpectraSite).

The income and gains in 2001 were more than offset by charges and losses, including combined expenses of approximately \$401 related to valuation adjustments of Williams and certain other cost investments accounted for under Financial Accounting Standards Board Statement No. 115, "Accounting for Certain Investments in Debt and Equity Securities" (FAS 115). These valuation adjustments resulted from an evaluation that the decline was other than temporary. We also recognized a charge of \$341 indicated by a transaction pending as of December 31, 2001, to reduce the direct book value of our investment in Telecom Américas. The transaction closed in early 2002. Additionally, during 2001, we recognized a loss of approximately \$61 on the sale of Ameritech New Media, expenses of \$33 for dividends paid on preferred securities issued by Ameritech subsidiaries, and \$16 for minority interest. The amount of our 2001 minority interest expense significantly declined from 2000 due to the contribution of most of our wireless properties to Cingular in the fourth quarter of 2000. Additionally, in 2001, we recognized an expense of approximately \$581 related to an endowment of Amdocs shares to the SBC Foundation and income of approximately \$575 from the related mark-to-market adjustment on the Amdocs shares, for a net expense of \$6.

Results for 2000 included gains of approximately \$1,818 related to the sale of direct and indirect investments in MATÁV and Netcom GSM, two international equity affiliates, and from the contribution of our investment in ATL – Algar Telecom Leste S.A. (ATL), a Brazilian telecommunications company, to Telecom Américas. Also included were gains of approximately \$295 on the sales of our interests in Wer Liefert Was, the Aurec companies in Israel and certain cost investments. We also recorded gains of \$238 on the sale of Telmex L shares associated with our private purchase of a note receivable with characteristics that essentially offset future mark-to-market adjustments on the Debt Exchangeable for Common Stock (DECS). Additionally, we sold our remaining Telmex L shares not related to the DECS for a gain, which was partially offset by appreciation in the market value of Telmex L shares underlying the DECS, for a net gain of approximately \$117. Also included in 2000 were gains of approximately \$87 that were recognized for mark-to-market adjustments on shares of Amdocs used for deferred compensation. An offsetting deferred compensation expense was recorded in operations and support expense. These gains were partially offset by combined charges of \$242 related to valuation adjustments of SecurityLink and certain cost investments accounted for under FAS 115 and by lower income from our wireless minority interest and dividends paid on preferred securities issued by Ameritech subsidiaries of approximately \$208.

Income taxes decreased \$968, or 24.5%, in 2002 and \$864, or 17.9%, in 2001. Income taxes were lower in 2002 than in 2001 primarily due to lower income and a decrease in our effective tax rate. The lower effective tax rate is primarily related to lower state taxes, including reductions due to one-time changes in the legal forms of various entities, increased realization of foreign tax credits, adoption of FAS 142, which eliminates the amortization of goodwill, and tax benefits of \$280 from a restructuring to manage certain investments (see Note 9). Income taxes in 2001 were lower than 2000 primarily due to contributions to the SBC Foundation in the first quarter of 2001, which was the primary reason for the decrease in the effective tax rate for 2001.

Extraordinary item in 2001 included an extraordinary loss of \$18, net of taxes of \$10, related to the early redemption of \$1,000 of the TOPRS.

Cumulative Effect of Accounting Change of \$1,820 (net of tax benefit of \$5) in 2002 was related to our January 1 adoption of FAS 142, which means that we stopped amortizing goodwill, and at least annually we will test the remaining book value of goodwill for impairment. Any impairments subsequent to adoption will be recorded in operating expenses. We also stopped amortizing goodwill recorded on our equity investments. We will continue to test this embedded goodwill under the accounting rules for equity investments, which are based on comparisons between fair value and carrying value.

During the first quarter of 2002, in accordance with FAS 142, we determined that goodwill related to our investment in Sterling Commerce Inc. (Sterling) was impaired by \$1,791. This impairment is recorded as a cumulative effect of accounting change on the income statement as of January 1, 2002. During the second quarter of 2002, Cingular determined that an impairment existed upon adopting FAS 142. Our portion of Cingular's impairment was \$19, with no income tax effect. As required by FAS 142, we recorded this amount retroactive to January 1, 2002. During the fourth quarter of 2002, América Móvil completed its analysis of the impact of adopting FAS 142 on its investment in CompUSA and determined the amount of an impairment that existed. Our portion of América Móvil's impairment was \$10, net of an income tax benefit of \$5. As required by FAS 142, we recorded this amount retroactive to January 1, 2002. Our other international holdings have completed their FAS 142 impairment analyses; we did not record any additional cumulative effect as a result. (See Note 1)

Segment Results

Our operating segments represent strategic business units that offer different products and services and are managed accordingly. As required by GAAP, our operating segment results presented in Note 4 and discussed below for each segment follow our internal management reporting. Our internal management reporting generally follows our reported results with two exceptions. First, we exclude special items from our segment results and analyze them separately. Second, while Cingular's results are included in our reported results under equity in net income of affiliates, we continue to manage the wireless business as a separate segment. Accordingly, we continue to analyze our wireless segment's results by including 60% of Cingular's revenues and expenses, an amount which equals our economic ownership percentage. Our decision to include 60% of Cingular's revenues and expenses in our wireless segment's results (rather than in equity in net income of affiliates) will change our segment revenues, expenses, operating income and nonoperating items, but will not change our reported net income.

In each of the following segments are the explanations of the special items. These items are discussed in the segment most closely associated with the legal entity affected by each special item. As noted above, these special items are not part of our operating segment results discussed below and reported in Note 4.

Under GAAP segment reporting rules, we analyze our various operating segments based on segment income and, as noted above, we exclude special items and analyze them separately. Interest expense, interest income and other income (expense) – net are managed only on a total company basis and are, accordingly, reflected in the other

segment. Therefore, these items are not included in the calculation of each segment's percentage of our consolidated segment income discussed below.

Beginning with the release of our first-quarter 2003 results, we will be providing expanded information for our segments. To that end, we expect to revise each segment's "operations and support expenses" line item to include separate discussions on individual components. While we are currently determining these components, we expect them to include selling, general and administrative expenses and cost of sales. We will also provide the expanded information for our segment results for 2002 and 2001.

The *wireline segment*, which accounted for approximately 74% of our consolidated segment operating revenues and 58% of our consolidated segment income in 2002, operates as both a retail and wholesale seller of communications services. We provide landline telecommunications services, including local and long-distance voice, switched access, messaging service, and data.

Prior to the fourth quarter of 2000, the *wireless segment*, which accounted for approximately 17% of our consolidated segment operating revenues and 12% of our consolidated segment income in 2002, included our consolidated businesses that provided wireless telecommunications services and sold wireless equipment. In October 2000, we contributed substantially all of our wireless businesses to Cingular and began reporting results from Cingular's operations as equity in net income of affiliates in our reported results (see our consolidated financial statements). However, when analyzing our operating segment results, we continue to evaluate Cingular's performance in our wireless segment. This means that we include 60% of Cingular's revenues and expenses, which equals our economic ownership percentage, in our wireless segment. Cingular offers both wireless voice and data communications services across most of the United States, providing cellular and PCS services.

The *directory segment*, which accounted for approximately 9% of our consolidated segment operating revenues and 21% of our consolidated segment income in 2002, includes all directory operations, including Yellow and White Pages advertising and electronic publishing. All investments with primarily international operations are included in the *international segment*, which accounted for less than 1% of our consolidated segment operating revenues and 7% of our consolidated segment income in 2002.

The following tables show components of results of operations by segment. A discussion of significant segment results is also presented following each table. Capital expenditures for each segment are discussed in "Liquidity and Capital Resources".

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FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Dollars in millions except per share amounts

Wireline

Segment Results

	2002	2001	2000	Percent Change	
				2002 vs. 2001	2001 vs. 2000
Segment operating revenues					
Voice	\$24,716	\$26,676	\$26,950	(7.3)%	(1.0)%
Data	9,639	9,631	8,181	0.1	17.7
Long-distance voice	2,324	2,436	2,525	(4.6)	(3.5)
Other	1,713	1,947	2,235	(12.0)	(12.9)
Total Segment Operating Revenues	38,392	40,690	39,891	(5.6)	2.0
Segment operating expenses					
Operations and support	23,008	24,315	23,659	(5.4)	2.8
Depreciation and amortization	8,442	8,383	7,869	0.7	6.5
Total Segment Operating Expenses	31,450	32,698	31,528	(3.8)	3.7
Segment Operating Income	6,942	7,992	8,363	(13.1)	(4.4)
Equity in Net Income of Affiliates	—	—	(12)	—	—
Segment Income	\$ 6,942	\$ 7,992	\$ 8,351	(13.1)%	(4.3)%

Excluded from the above segment income are the following special items:

	2002		2001		2000
A	\$859	C	\$(959)	G	\$ (444)
B	125	D	6	H	1,070
		E	197		
		F	600		

- A. On a total company basis, we had combined charges of \$872 (recorded in reported operating expenses) for enhanced pension benefits, pension settlements, severance costs and real estate costs related to work force-reduction programs; \$859 of this related to wireline entities.
- B. Additional bad debt reserves of \$125 (recorded in reported operating expenses) as a result of the July 2002 WorldCom Inc. (WorldCom) bankruptcy filing, related to wireline entities.
- C. On a total company basis, we had pension settlement gains of \$(1,097) (recorded in reported operating expenses) related to management employees, primarily resulting from a fourth-quarter 2000 voluntary retirement program net of costs associated with that program; \$(959) of this related to wireline entities.
- D. On a total company basis, we had combined charges of \$316 (recorded in reported operating expenses) related to impairment of our cable operations; \$6 of this related to wireline entities.
- E. A charge of \$197 (recorded in reported operating expenses) representing a proposed settlement agreement with the Illinois Commerce Commission (ICC) related to a provision of the Ameritech merger, related to wireline entities. The amount represents an estimate of all future savings to be shared with our Illinois customers.
- F. On a total company basis, we had combined charges of \$619 (recorded in reported operating expenses) associated with our comprehensive review of operations in the fourth quarter of 2001, which resulted in decisions

to reduce work force, terminate certain real estate leases and shut down certain operations (see Note 2); \$600 of this related to wireline entities.

- G. On a total company basis, we had pension settlement gains of \$(512) (recorded in reported operating expenses and equity in net income of affiliates) associated with pension litigation, first-quarter payments primarily related to employees who terminated employment during 1999 and gains resulting from a voluntary retirement program net of enhanced pension and postretirement benefits associated with that program (see Note 10); \$(444) of this related to wireline entities.
- H. On a total company basis, we had costs of \$1,183 (recorded in reported operating expenses) associated with strategic initiatives and other adjustments resulting from the merger integration process with Ameritech; \$1,070 of this related to wireline entities.

In the second quarter of 2002, we began reporting product-based revenue categories for this segment. The new categories, voice, data and long-distance voice, are more closely aligned with how we currently manage the business. Our wireline segment operating income margin was 18.1% in 2002, compared to 19.6% in 2001 and 21.0% in 2000. The declines in our wireline segment operating income margin were due primarily to the loss of revenues from retail access lines caused by providing below-cost UNE-Ps to competitors. This revenue decline was greater than our expense reductions in response to UNE-P pricing, the weak U.S. economy, and increased competition, including technology substitution. The overall effect was a decline of 13.1% in wireline segment income. See below for further discussion of the details of our wireline segment revenue and expense.

Voice revenues decreased \$1,960, or 7.3%, in 2002 and \$274, or 1.0%, in 2001 due primarily to the loss of retail access lines caused by providing below-cost UNE-P, the weak U.S. economy, and increased competition, including technology substitution. See further discussion on the impacts of UNE-P in "Operating Environment and Trends

of the Business". During 2002, as compared to 2001, our retail consumer and business access lines decreased by 9.1% and 6.7% respectively, and our total access lines declined by 4.1%. During 2001, as compared to the prior year, our retail consumer and business access lines decreased by 4.3% and 4.5% respectively, and our total access lines declined by 2.8%. The revenue decreases associated with these continued access-line declines were approximately \$1,117 in 2002 and \$634 in 2001. In 2002, vertical services revenues (e.g., Caller ID and voice mail) decreased approximately \$168, also due in part to access-line declines.

Equipment sales declined approximately \$248, and continued declines in our payphone business decreased revenue by approximately \$130 in 2002. Voice revenues decreased \$86 due to the July 2000 Coalition for Affordable Local and Long Distance Service (CALLS) order which capped prices for certain services. Revenue also decreased approximately \$212 due to usage-based pricing (versus fixed fees) and other pricing responses to competitors' offerings. Revenue was also lower in 2002 by approximately \$117 due to June 2001 Illinois legislation which increased 2001 revenues. The June 2001 Illinois legislation imposed new requirements on Illinois telecommunications companies relating to service standards, service offerings and competitive access to our network. Revenue in 2002 was also lower by approximately \$66 due to the reversal of an accrual related to an FCC rate-related issue which increased 2001 revenue. The remainder of the decrease in 2002 was due to various demand-related declines. Partially offsetting these revenue declines, wholesale revenues increased approximately \$200. The 2002 degree of increase was less than the increase for 2001, reflecting a shift from resale lines (which have higher rates compared to UNE-P) to UNE-P lines provided to competitors.

In 2001, in addition to the decline in access-line revenues discussed above, revenues from equipment sales decreased approximately \$114 and revenue from our payphone business decreased \$155. Voice revenues also decreased approximately \$283 during 2001 due to the impact of CALLS. Partially offsetting these revenue declines, wholesale revenues increased approximately \$455 and revenue from vertical services increased approximately \$127; however, the sequential quarterly growth rate for vertical services during the year steadily declined. Revenue in 2001 also increased approximately \$247 due to the June 2001 Illinois legislation and \$66 due to the FCC rate-related issue mentioned above.

Data revenues increased \$8, or 0.1%, in 2002 and \$1,450, or 17.7%, in 2001, due primarily to increased data transport services revenues. Overall data growth continued to slow throughout 2002 due to the weak U.S. economy and, in particular, by cutbacks at internet service providers (ISPs) and wholesale (long-distance and competitive local service providers) customers.

Data transport services represented about 75% of our total data revenues in both 2002 and 2001 and increased 5.2% in 2002 and 20.6% in 2001. DSL, our broadband internet-access service, increased data transport revenues by approximately \$326 in 2002 and \$319 in 2001. DSL lines grew to approximately 2,199,000 in 2002 compared to 1,333,000 at the end of 2001 and 767,000 at the end of

2000. We expect DSL to make a positive contribution to wireline segment income in the next 12 to 18 months. Continued demand for certain high-capacity services such as DS3s, SONET (a dedicated high-speed solution for multi-site businesses), and ATM increased by approximately \$109 in 2002 and \$980 in 2001. The impact of CALLS decreased data transport revenue approximately \$78 in 2002 and \$76 in 2001. Revenue from our e-commerce offerings showed a net increase in revenue of approximately \$152 in 2002 and \$131 in 2001. The 2002 increase in e-commerce revenue was primarily due to our acquisition of Prodigy in late 2001.

The increases in data transport and e-commerce services were virtually offset in 2002 by a decrease of approximately \$537 in revenues from data equipment sales and network integration services. In 2001, revenue from data equipment sales and network integration services increased approximately \$114; however, revenue declined sequentially during the second half of the year primarily due to our efforts in the third quarter of 2001 to de-emphasize low-margin equipment sales.

Long-distance voice revenues decreased \$112, or 4.6%, in 2002 and \$89, or 3.5%, in 2001 reflecting declines in retail local toll revenues primarily due to competition in all 13 states only partially offset by increases in long-distance revenues in the states where we were authorized to offer it. During 2002, retail intraLATA long-distance (local toll) revenues decreased approximately \$381, caused partially by a decline in minutes of use during the year of approximately 19.6%, which decreased revenues by approximately \$171. IntraLATA revenues also decreased approximately \$85 resulting from access line losses. As we have already opened our markets to competition, which is a requirement to gain approval to offer interLATA long-distance (traditional long-distance) in our entire 13-state area, we expect further losses in intraLATA revenues. Partially offsetting the intraLATA revenue decline, retail interLATA revenues increased approximately \$155, resulting from our 2001 entries into the Arkansas, Kansas, Missouri and Oklahoma long-distance markets in addition to our previous entries into the Texas and Connecticut markets. Future interLATA revenues will reflect our December 2002 entry into the California market. The status of our interLATA long-distance entry into our six remaining in-region states is discussed in "Expected Growth Areas".

Revenue of approximately \$114 from wholesale long-distance services provided to Cingular under a 2002 related-party agreement also offset the decrease in total long-distance voice revenue during 2002. However, this did not have a material impact on our net income as the long-distance revenue was mostly offset when we recorded our share of equity income in Cingular. Excluding the revenues generated from our agreement with Cingular, long-distance voice revenues decreased approximately \$226, or 9.3%, in 2002.

In 2001, long-distance service revenues decreased approximately \$245 due to competitive losses resulting from competitors' customers no longer being required to dial special access codes for local toll calls and \$146 attributable to competitive pricing actions in the Ameritech region. These losses were partially offset by an increase of

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Dollars in millions except per share amounts

approximately \$322 resulting from our entries into the long-distance markets mentioned above.

Other operating revenues decreased \$234, or 12.0%, in 2002 and \$288, or 12.9%, in 2001. Demand for directory and operator assistance, carrier billing and collection, and other miscellaneous products and services decreased approximately \$127 in 2002 and \$88 in 2001. Partially offsetting these decreases, price increases added revenue of approximately \$63 in 2002. Pricing actions decreased revenues approximately \$113 in 2001. In addition, adjustments to our deferred activation revenues decreased revenues in 2002, but increased revenues in 2001.

Operations and support expenses decreased \$1,307, or 5.4%, in 2002 and increased \$656, or 2.8%, in 2001. Costs associated with equipment sales and related network integration services decreased approximately \$711 in 2002, compared to an increase of \$70 in 2001, primarily due to previous efforts to de-emphasize low-margin equipment sales. Primarily in response to below-cost UNE-P pricing, we have continued to reduce our work force, consequently decreasing expenses approximately \$571 in 2002. We do not experience any significant reduction in expenses for retail access lines lost to UNE-P pricing as we must provide the network support for those lines marketed by our competitors. Other nonemployee-related expenses such as contract services, agent commissions and materials and supplies costs decreased approximately \$288 in 2002 as we responded to the current regulatory and economic environment. Termination of most management vacation carry-over policies and reductions in other employee-related expenses such as travel, training and conferences decreased expenses approximately \$300 in 2002. Reciprocal compensation expense increased approximately \$44 in 2002 primarily due to growth in wireless and competitive local exchange carrier minutes of use on our network, partially offset by lower rates in effect during the year. This compares to an increase in reciprocal compensation of approximately \$185 in 2001. Approximately \$134 of the decrease in 2002 was primarily due to one-time expenses incurred in 2001 to implement Illinois legislation discussed in "Voice" revenues above. Our provision for uncollectible accounts

decreased approximately \$138 in 2002, which included a reversal of approximately \$36 related to a change in our estimate of how long it takes to collect a delinquent account. Our methodology is discussed under "Accounting Policies and Standards".

The cost of providing our pension and health-care benefits increased approximately \$682 in 2002 primarily due to a decreased asset base of our employee pension benefit plans from net investment losses and previous recognition of pension settlement gains reducing the amount of unrealized gains recognized in the current year. Increased medical and prescription drug claim costs and the reduction in the discount rate used for determining our pension and postretirement projected benefit obligations also contributed to increased personnel benefit costs in 2002. These matters are more fully discussed above under "Consolidated Results - Operating expenses".

Our provision for uncollectible accounts increased approximately \$540 in 2001, as we experienced greater losses on receivables due to the weak U.S. economic environment. Costs to restore the quality of service in our midwest region, along with our entry into the traditional long-distance market in four states, increased expenses approximately \$580 in 2001. Costs associated with the launch of our DSL service and our acquisition of Prodigy late in 2001 increased expenses approximately \$170 in 2001. Expenses decreased approximately \$635 in 2001 due to work force-reductions, early retirements, lower personnel benefit costs and gains from certain employee postretirement plans.

Depreciation and amortization expenses increased \$59, or 0.7%, in 2002 and increased \$514, or 6.5%, in 2001. The increase in 2002 is primarily due to higher plant levels although the rate of increase was limited by our reduced capital expenditures. This increase was partially offset by approximately \$161 in 2002, as goodwill is no longer amortized in accordance with FAS 142 (see Note 1). The majority of the increase in 2001 was related to higher plant levels from the build-out of our broadband network and launch of new products and services, including DSL and internet data centers.

Wireless

Segment Results

	2002	2001	2000	Percent Change	
				2002 vs. 2001	2001 vs. 2000
Segment operating revenues					
Subscriber revenue	\$7,745	\$7,307	\$6,480	6.0%	12.8%
Other	1,091	1,340	1,462	(18.6)	(8.3)
Total Segment Operating Revenues	8,836	8,647	7,942	2.2	8.9
Segment operating expenses					
Operations and support	6,093	5,957	5,348	2.3	11.4
Depreciation and amortization	1,240	1,232	1,083	0.6	13.8
Total Segment Operating Expenses	7,333	7,189	6,431	2.0	11.8
Segment Operating Income	1,503	1,458	1,511	3.1	(3.5)
Equity in Net Income of Affiliates	(4)	(11)	12	63.6	—
Segment Income	\$1,499	\$1,447	\$1,523	3.6%	(5.0)%

Excluded from the above segment income in 2002 is the following special item:

- A charge of \$142 in 2002 (recorded in equity in net income of affiliates for reported results) for our proportionate share of impairments, severance and restructuring costs at Cingular. The impairments included, among other items, write-downs related to Cingular interactive paging and transmission equipment in markets with complete system conversions.

We account for our 60% economic interest in Cingular under the equity method of accounting in our consolidated financial statements since we share control equally (i.e. 50/50) with our 40% economic partner in the joint venture. We have equal voting rights and representation on the board of directors that controls Cingular. This means that our reported results include Cingular's results in the "Equity in Net Income of Affiliates" line. However, when analyzing our segment results, we evaluate Cingular's results as part of the wireless segment. Accordingly, in the segment table above, we include 60% of the Cingular revenues and expenses under "Segment operating revenues" and "Segment operating expenses", excluding \$142 of expenses noted in the special item above. Including 60% of Cingular's results in our segment operations (rather than in equity in net income of affiliates) changes our wireless segment's revenues, expenses, operating income and nonoperating items, but does not change our wireless segment income, consolidated segment net income, or reported net income. We also include our proportionate share of depreciation and amortization expense from the Cingular-T-Mobile USA, Inc. (T-Mobile) (formerly known as VoiceStream Wireless Corporation) network sharing agreement, which Cingular accounts for on the equity method of accounting. The results in the table above also include our residual wireless properties that we hold which have not been contributed to Cingular.

Our wireless segment operating income margin was 17.0% in 2002, 16.9% in 2001 and 19.0% in 2000. Cingular's addition of quality postpaid customers and ability to reduce system costs per minute of use in 2002, as compared to 2001, have helped to maintain the stable segment operating income margin for those years. See further discussion of the details of our wireless segment revenues and expenses below.

Subscriber revenues increased \$438, or 6.0%, in 2002 and \$827, or 12.8%, in 2001. The 2002 increase was primarily driven by Cingular's continued focus on quality postpaid customer growth, which increased 4.9% in 2002. However, these postpaid customer additions are increasing at a lesser rate than in prior periods. Also contributing to the increased revenues were handset guaranty premiums paid by customers to a new Cingular insurance subsidiary. Although not yet a significant part of Cingular's business, data revenues increased 48.2%.

Partially offsetting these increases were decreased long-distance and incollect roaming revenues, which will continue as Cingular continues to market rate plans that include these

features for no additional charge. During 2002, Cingular experienced a 45.1% decrease in subscribers served through reseller agreements. Reseller customers comprise approximately 3% of Cingular's customer base and contributed to the decreased subscriber revenues. On average, Cingular has four to five other wireless competitors in each of its markets. At December 31, 2002, Cingular had approximately 21,925,000 cellular/PCS customers, as compared to 21,596,000 at December 31, 2001.

The 2001 increase was primarily related to growth in customer base accompanied by existing customers shifting to higher monthly rate plans, increased minutes of use and the sale of higher access rate plans to new customers. During 2001, Cingular focused on policies that had the effect of shifting subscribers from analog plans to digital plans.

Other revenues decreased \$249, or 18.6%, in 2002 and \$122, or 8.3%, in 2001. The 2002 decrease was primarily due to reductions in roaming rates with major roaming partners to support all-inclusive rate plans and decreased minutes of use on Cingular's network caused by the continued build-out of competitors' networks. Also contributing to the decline in other revenues were decreased equipment revenues, reflecting the decrease in customer additions, which was partially offset by revenues associated with a 2002 equipment upgrade promotion.

The 2001 decrease was due to a decline in roaming revenues from other carriers, reflecting the continued build-out of competitors' networks, which resulted in fewer of their customers' minutes on Cingular's network and lower negotiated rates with other carriers. Equipment revenues also declined due to a lower customer growth rate in 2001.

Operations and support expenses increased \$136, or 2.3%, in 2002 and \$609, or 11.4%, in 2001. The 2002 increase was primarily due to significant increases in minutes of use on the network, and increased incollect roaming and long-distance costs, which were driven by customer migrations to rate plans that include these services for no additional charge. Minutes of use increased approximately 34% over the prior year, which was primarily caused by demand for digital plans with more included minutes and off-peak promotions, which allow for a large number of free minutes.

The 2001 increase was primarily due to increased minutes of use on the network, increased long-distance expenses as more plans included free long-distance, and the Cingular national branding campaign that was completed in 2001. These increases were partially offset by new long-distance rates with BellSouth and SBC that became effective June 2001 and administrative cost savings gained through the formation of Cingular.

Depreciation and amortization expenses increased by \$8, or 0.6%, in 2002 and \$149, or 13.8%, in 2001. The 2002 increase was due to higher plant levels that were mostly offset by a decrease of approximately \$182, as goodwill and FCC licenses are no longer amortized in accordance with FAS 142 (see Note 1). The 2001 increase was due to higher plant levels.

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FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)
Dollars in millions except per share amounts

Directory

Segment Results

	2002	2001	2000	Percent Change	
				2002 vs. 2001	2001 vs. 2000
Segment Operating Revenues	\$4,451	\$4,468	\$4,340	(0.4)%	2.9%
Segment operating expenses					
Operations and support	1,928	1,907	2,017	1.1	(5.5)
Depreciation and amortization	30	36	32	(16.7)	12.5
Total Segment Operating Expenses	1,958	1,943	2,049	0.8	(5.2)
Segment Income	\$2,493	\$2,525	\$2,291	(1.3)%	10.2%

Excluded from the above segment income are the following special items:

	2002		2001		2000
A	\$3	B	\$(24)	D	\$(17)
		C	19	E	30

- A. On a total company basis, we had combined charges of \$872 (recorded in reported operating expenses) for enhanced pension benefits, pension settlements, severance costs and real estate costs related to work force-reduction programs; \$3 of this related to directory entities.
- B. On a total company basis, we had pension settlement gains of \$(1,097) (recorded in reported operating expenses) related to management employees, primarily resulting from a fourth-quarter 2000 voluntary retirement program net of costs associated with that program; \$(24) of this related to directory entities.
- C. On a total company basis, we had combined charges of \$619 (recorded in reported operating expenses) associated with our comprehensive review of operations in the fourth quarter of 2001, which resulted in decisions to reduce work force, terminate certain real estate leases and shut down certain operations (see Note 2); \$19 of this related to directory entities.
- D. On a total company basis, we had pension settlement gains of \$(512) (recorded in reported operating expenses and equity in net income of affiliates) associated with pension litigation, first-quarter payments primarily related to employees who terminated employment during 1999 and gains resulting from a voluntary retirement program net of enhanced pension and postretirement benefits associated with that program (see Note 10); \$(17) of this related to directory entities.
- E. On a total company basis, we had costs of \$1,183 (recorded in reported operating expenses) associated with strategic initiatives and other adjustments resulting from the merger integration process with Ameritech; \$30 of this related to directory entities.

Our directory segment income margin was 56.0% in 2002, compared to 56.5% in 2001 and 52.8% in 2000. Directory revenues decreased and expenses increased in 2002, reflecting increased competition and a weak U.S. economy. Revenues increased in 2001 due to demand and expenses decreased due to merger efficiencies and cost-containment efforts. Occasionally, from period to period, we change the timing of our directory book publication dates. The timing of these directory publication dates is changed for various reasons, including maximizing the efficiency of the sales force and responding to competitors' offerings.

Segment operating revenues decreased \$17, or 0.4%, in 2002 and increased \$128, or 2.9%, in 2001. The decreased revenues in 2002 primarily related to a decrease in demand of approximately \$47 while the increased revenues in 2001 were related to increased demand of approximately \$49. The decreased revenues in 2002 were partially offset by a net change in the timing of directory publications of approximately \$30 in 2002 and \$79 in 2001. The change in timing is the result of a decrease of approximately \$110 in 2002 and \$47 in 2001 related to books that were published one less time than in the previous year. This was partially offset by an increase of \$13 in 2002 and \$2 in 2001 due to books published in that calendar year but not the previous calendar year. Finally, the change in timing included an increase of approximately \$127 in 2002 and \$124 in 2001 from extensions of book publication dates within the same calendar year.

Operations and support expenses increased \$21, or 1.1%, in 2002 and decreased \$110, or 5.5%, in 2001. The increased expenses for 2002 were due to higher pension and benefit-related costs. The increased expenses were partially offset by an approximately \$26 decrease in expenses associated with changes in publications dates. The decrease in expense in 2001 was primarily related to lower compensation related expenses, as a result of merger initiatives, a 2000 pension and retirement program, and cost-containment efforts. This 2001 decrease was partially offset by an approximately \$37 increase from expenses associated with shifts in directory publication dates.

International

Segment Results

	2002	2001	2000	Percent Change	
				2002 vs. 2001	2001 vs. 2000
Segment Operating Revenues	\$ 35	\$185	\$328	(81.1)%	(43.6)%
Segment Operating Expenses	85	243	476	(65.0)	(48.9)
Segment Operating Income (Loss)	(50)	(58)	(148)	13.8	60.8
Equity in Net Income of Affiliates	926	800	862	15.8	(7.2)
Segment Income	\$876	\$742	\$714	18.1%	3.9%

Excluded from the above segment income are the following special items:

	2002		2001		2000
A	\$(326)	C	\$ (2)	F	\$(68)
B	101	D	49	G	3
		E	197		

- A. Income of \$(326) (recorded in reported equity in net income of affiliates) related to international entities and consisting of 1) income of \$(371) from our proportionate share of the gains at TDC and Belgacom related to the disposition of their Netherlands wireless operations as a result of a call by a subsidiary of Deutsche Telekom A.G. (Deutsche Telekom). The components of this amount included a gain at Belgacom of \$(75) on the disposition and a direct and indirect gain at TDC of \$(296); 2) a gain of \$(13) for a reduction in a previously recorded restructuring accrual at a TDC affiliate; and 3) a charge of \$58 related to impairments on TDC's investments in Poland, Norway and the Czech Republic.
- B. A charge of \$101 (recorded in reported equity in net income of affiliates) related to international entities and representing our proportionate share of restructuring costs at Belgacom. These costs were primarily related to a work force-reduction initiative.
- C. On a total company basis, we had pension settlement gains of \$(1,097) (recorded in reported operating expenses) related to management employees, primarily resulting from a fourth-quarter 2000 voluntary retirement program net of costs associated with that program; \$(2) of this related to international entities.
- D. A charge of \$49 (recorded in reported equity in net income of affiliates) indicated by a transaction pending as of December 31, 2001, to reduce the indirect book value of our investment in Telecom Américas, related to international entities.
- E. A charge of \$197 (recorded in reported equity in net income of affiliates) for costs related to TDC's decision to discontinue nonwireless operations of its Talkline subsidiary and our impairment of the goodwill we allocated to Talkline, related to international entities.
- F. Gains of \$(68) (recorded in reported equity in net income of affiliates) related to the sale of our indirect investment in Netcom GSM, an international equity affiliate.

- G. On a total company basis, we had pension settlement gains of \$(512) (recorded in reported operating expenses and equity in net income of affiliates) associated with pension litigation, first-quarter payments primarily related to employees who terminated employment during 1999 and gains resulting from a voluntary retirement program net of enhanced pension and postretirement benefits associated with that program (see Note 10); \$3 of this related to international entities.

Our international segment consists almost entirely of equity investments in international companies, the income from which we report as equity in net income of affiliates. Revenues from direct international operations are less than 1% of our consolidated revenues. Results for 2002 largely reflect the January 1, 2002 adoption of FAS 142 by our international holdings, which eliminated the amortization of goodwill embedded in our equity investments, and lower operating expenses. As discussed below, this adoption had the effect of increasing segment income. Partially offsetting this increase was the prior sale of an international investment resulting in decreased 2002 long-distance revenues. We discuss our annual results first and then summarize in a table the individual results for our significant equity holdings.

Our earnings from foreign affiliates are sensitive to exchange-rate changes in the value of the respective local currencies. See Note 8 for a discussion of how we manage foreign-exchange risk. Our foreign investments are recorded under GAAP, which include adjustments for the purchase method of accounting and exclude certain adjustments required for local reporting in specific countries.

Segment operating revenues decreased \$150, or 81.1%, in 2002 and \$143, or 43.6%, in 2001. Revenues declined due to the September 2001 disposition of Ameritech Global Gateway Services (AGGS), our international long-distance subsidiary, and lower management-fee revenues. Lower long-distance activity prior to our disposition of AGGS also contributed to the 2001 decrease.

Segment operating expenses decreased \$158, or 65.0%, and \$233, or 48.9%, in 2001. The decrease was primarily due to the disposition of AGGS. Also contributing to the 2001 decrease was lower long-distance activity prior to the AGGS disposition and reduced depreciation expense due to certain property, plant and equipment being fully depreciated during the first quarter of 2001.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Dollars in millions except per share amounts

Equity in net income of affiliates increased \$126, or 15.8%, in 2002 and decreased \$62, or 7.2%, in 2001. The 2002 increase includes approximately \$220 resulting from the January 1, 2002 adoption of FAS 142, which eliminated the amortization of goodwill embedded in our investments in equity affiliates. Excluding the effects of adopting FAS 142, our equity in net income of affiliates would have decreased \$94, or 11.8%, in 2002.

Increases in equity in net income of affiliates for 2002 consisted of a gain of approximately \$145 from Belgacom's sale of a portion of its Netherlands wireless operations to an unaffiliated special purpose entity (SPE). The 2002 gain was approximately \$81 higher than a similar gain in 2001 of approximately \$64. As part of the original transaction, the SPE had the right to put the investment to a subsidiary of Deutsche Telekom. During September 2002, the remaining shares of the Netherlands wireless operations that were held by Belgacom and TDC were called, noted in special item A above. Equity in net income of affiliates in 2002 also increased due to the 2001 loss of approximately \$32 on Belgacom's sale of its French internet business, Infonie.

Decreasing 2002 equity in net income of affiliates were restructuring charges of approximately \$58 taken in 2002 by Bell Canada and the prior-year one-time gain of approximately \$49 on Bell Canada's 2001 sale of Sympatico-Lycos, partially offset by a one-time gain of approximately \$28 from Bell Canada's partial sale of Telebec in 2002. Our equity income from Bell Canada was also lower as compared to 2001 by approximately \$101 as a result of our May 2002 change from the equity method to the cost method of accounting for that investment. Our removal from day-to-day management and the progression of negotiations to sell our interest in Bell Canada resulted in this change (see Note 2). A 2001 gain on the sale of AOL France by Cegetel S.A. (Cegetel) decreased 2002 equity in net income of affiliates approximately \$53.

The 2001 decrease includes a decrease of approximately \$295 from Belgacom and TDC, primarily related to decreased earnings from their foreign affiliates and the inclusion in

2000 results of the gain on the sale of Telenordia, partially offset by the gain of approximately \$64 related to Belgacom's fourth-quarter 2001 sale of a portion of its Netherlands wireless operations to an unaffiliated SPE. The third-quarter 2000 sale of our investment in MATÁV reduced earnings approximately \$65 in 2001 as compared to 2000. Lower income from South American wireless companies held by América Móvil, certain true-up adjustments in 2000 at Telmex and our smaller ownership percentage at these affiliates resulted in a decrease of approximately \$26.

Offsetting these 2001 decreases were increases of approximately \$92 resulting from wireless subscriber growth, higher average revenue per customer and Cegetel's second-quarter 2001 sale of AOL France. Bell Canada's first-quarter 2001 gain on their disposition of an ISP subsidiary and improved operating results contributed approximately \$74 to the increase in 2001. Also offsetting the decrease was the elimination of losses, on a comparative basis, of approximately \$139 resulting from the first-quarter 2001 disposition of diAx A.G. (diAx), a Swiss mobile and landline operator, and the exchange of our equity investment in ATL for a cost investment in Telecom Américas.

Our equity in net income of affiliates by major investment at December 31, are listed below:

	2002	2001	2000
América Móvil	\$ 60	\$ 10	\$ —
Belgacom	215	85	125
Bell Canada	53	176	102
Cegetel	88	94	2
TDC	258	40	295
Telkom South Africa	31	54	30
Telmex	219	325	361
Other	2	16	(53)
International Equity in Net			
Income of Affiliates	\$926	\$800	\$862

América Móvil was spun-off from Telmex in 2001.

Other

Segment Results

	2002	2001	2000	Percent Change	
				2002 vs. 2001	2001 vs. 2000
Segment Operating Revenues	\$389	\$586	\$1,098	(33.6)%	(46.6)%
Segment Operating Expenses	146	450	994	(67.6)	(54.7)
Segment Operating Income	\$243	\$136	\$ 104	78.7%	30.8%

Excluded from the above segment operating income are the following special items:

	2002		2001		2000
A	\$10	B	\$(112)	D	\$(54)
		C	310	E	83
				F	132
				G	619

- A. On a total company basis, we had combined charges of \$872 (recorded in reported operating expenses) for enhanced pension benefits, pension settlements, severance costs and real estate costs related to work force-reduction programs; \$10 of this related to other entities.
- B. On a total company basis, we had pension settlement gains of \$(1,097) (recorded in reported operating expenses) related to management employees, primarily resulting from a fourth-quarter 2000 voluntary retirement program net of costs associated with that program; \$(112) of this related to other entities.
- C. On a total company basis, we had combined charges of \$316 (recorded in reported operating expenses) related to impairment of our cable operations; \$310 of this related to other entities.
- D. On a total company basis, we had pension settlement gains of \$(512) (recorded in reported operating expenses and equity in net income of affiliates) associated with pension litigation, first-quarter payments primarily related to employees who terminated employment during 1999 and gains resulting from a voluntary retirement program net of enhanced pension and postretirement benefits associated with that program (see Note 10); \$(54) of this related to other entities.
- E. On a total company basis, we had costs of \$1,183 (recorded in reported operating expenses) associated with strategic initiatives and other adjustments resulting from the merger integration process with Ameritech; \$83 of this related to other entities.
- F. A charge of \$132, related to other entities (recorded in reported operating expenses) related to in-process research and development from the March 2000 acquisition of Sterling (see Note 2).
- G. Combined charges of \$619, related to other entities (recorded in reported operating expenses) related to valuation adjustments of SecurityLink and the restructure of agreements with Prodigy (see Note 2).

Our other segment results in 2002 primarily consist of corporate and other operations. The 2001 results primarily include our Ameritech cable television operations, which we sold in November 2001. The 2000 results include our Ameritech security monitoring business, which we sold in January 2001. See Note 2 for further details on these dispositions.

OPERATING ENVIRONMENT AND TRENDS OF THE BUSINESS

2003 Revenue Trends For 2003, we expect current economic and competitive trends to continue. We expect continued losses in access-lines, and associated revenues due to the effects of UNE-P and competition. We expect these losses to be partially offset later in the year by interLATA long-distance entry into our remaining in-region states and marketing of new combinations of our products (bundling). We expect modest growth in data transport revenues, reflecting the weak economy and continued cutbacks by our wholesale customers. We expect modest subscriber and revenue growth at Cingular. Overall, we expect total consolidated revenue to decline slightly in 2003.

2003 Pension and Retiree Medical Cost Expense Trends

As a result of rising medical and prescription drug costs, economic impacts and assumption changes discussed below, we expect combined net pension and postretirement cost of between \$1,800 and \$2,000 (\$0.36 to \$0.40 per share) in 2003, compared to our combined net pension and postretirement benefit of \$82 in 2002. Approximately 10% of these costs will be capitalized as part of construction labor, providing a small reduction in the net expense recorded. Certain factors, such as investment returns, depend largely on trends in the U.S. securities market and the general U.S. economy. Our ability to improve the performance of those factors is limited. In particular, a continued weakness in the securities markets and U.S. economy could result in investment losses and a decline in plan assets, which under GAAP we will recognize over the next several years. Should the securities markets continue to decline and medical and prescription drug costs continue to increase significantly, we would expect increasing annual combined net pension and postretirement cost for the next several years. Additionally, should actual experience differ from actuarial assumptions, combined net pension and postretirement cost would be affected in future years.

The weighted average expected return on assets assumption, which reflects our view of long-term returns, is one of the most significant of the weighted average assumptions used to determine our actuarial estimates of pension and postretirement benefit expense. Based on our long-term expectations of market returns in future years, we lowered our long-term rate of return on plan assets from 9.5% to 8.5% for 2003. If all other factors were to remain unchanged, we expect a 1% decrease in the expected long-term rate of return would cause 2003 combined pension and postretirement cost to increase approximately \$342 over 2002 (analogous change would result from a 1% increase). Also, rising medical and prescription drug costs caused us to increase our assumed medical expense trend rate for 2003 from 8.0% to 9.0% for retirees 64 and under and from 9.0% to 10.0% for retirees 65 and over, trending to an expected increase of 5.0% in 2009 for all retirees.

Dollars in millions except per share amounts

Under GAAP, the expected long-term rate of return is calculated on the market-related value of assets (MRVA). GAAP requires that actual gains and losses on pension and postretirement plan assets be recognized in the MRVA equally over a period of not more than five years. We use a methodology, allowed under GAAP, under which we hold the MRVA to within 20% of the actual fair value of plan assets, which can have the effect of accelerating the recognition of excess actual gains and losses into the MRVA to less than five years. Due to investment losses on plan assets experienced in the last several years, we expect this methodology to contribute approximately \$605 to our combined net pension and postretirement cost in 2003 as compared with not using this methodology. This methodology did not have a significant effect on our 2002, 2001 or 2000 combined net pension and postretirement benefit as the MRVA was almost equal to the fair value of plan assets.

For the majority of our nonmanagement labor contracts that contain an annual dollar value cap for the purpose of determining contributions required from retirees, we have waived the cap during the relevant contract periods and thus not collected contributions from those nonmanagement retirees. Therefore, in accordance with the substantive plan provisions required in accounting for postretirement benefits under GAAP, we do not account for the cap in the value of our accumulated postretirement benefit obligation (i.e., we assume the cap will be waived for all future contract periods). If we were able to account for the cap as written in the contracts, our postretirement benefit cost would have been reduced by \$606, \$476 and \$571 in 2002, 2001 and 2000. We expect that not accounting for the cap as written in the contracts will result in approximately \$900 of postretirement benefit cost during 2003.

Other 2003 Expense Trends We expect total operating expenses to increase significantly in 2003, due primarily to increases in our pension and postretirement benefit costs as noted above. In addition, to support interLATA long-distance entry into our remaining in-region states and our bundling marketing initiatives, we expect our advertising expense to increase along with increases in our sales force. We expect the increase in our sales force numbers to be offset by declines in other areas of our work force.

Operating Environment Overview

Passage of the Telecommunications Act of 1996 (Telecom Act) was intended to promote competition and reduce regulation in U.S. telecommunications markets. Despite passage of the Telecom Act, the telecommunications industry, particularly incumbent local exchange carriers such as our wireline subsidiaries, and advanced services including DSL, continue to be subject to significant regulation. The expected transition from an industry extensively regulated by multiple regulatory bodies to a market-driven industry monitored by state and federal agencies has not occurred as anticipated.

Our wireline subsidiaries remain subject to extensive regulation by state regulatory commissions for intrastate services and by the FCC for interstate services. For example,

certain state commissions, including those in California, Illinois, Michigan, Ohio and Indiana, have significantly lowered the wholesale rates we are allowed to charge competitors, including AT&T and WorldCom, for leasing parts of our network (unbundled network elements, or UNEs). These mandated rates, which are below our cost, are significantly contributing to continuing declines in our access-line revenues and profitability. When UNEs are combined by incumbent local exchange carriers into a complete set capable of providing total local service to a customer, then they are referred to as UNE-P. Under UNE-P, our competitors market the lines and collect revenue from the customer, but we still incur the network costs. At December 31, 2002 we had lost approximately 5 million customer lines to competitors who obtained UNE-P lines from us, with approximately 2.6 million lost during 2002. These UNE-P regulations are also contributing to decreases in our switched access revenue and universal service fees and other fees, which have in the past substantially contributed financial support for the operation of the network for all customers.

During 2002, primarily in response to the impact of UNE-P, the sluggish economy, increased competition and substitution, we eliminated approximately 20,000 full-time employee and contractor positions (9,000 in the fourth quarter of 2002) and we reduced our 2003 capital expenditure budget to between \$5,000 and \$6,000, from the \$6,808 actual expenditures in 2002 (reflecting a reduction from the original total 2002 budget, which was between \$9,200 and \$9,700). In February 2003, the FCC completed its triennial review of UNE regulations. The FCC review included a wide range of UNE issues, including UNE-P, dark fiber (unused fiber that does not have a communications signal) and unbundled transmittal of communications services. Several state commissions are also reviewing UNE-P regulations. If current UNE-P regulations remain in place or are revised to be even more detrimental to our business, we could experience additional and more significant declines in access-line revenues, which, in turn, could reduce returns on our invested capital and result in further reductions in capital expenditures and employment levels. The text of the FCC's triennial review decision was not available as of the deadline for printing this Annual Report. A discussion of the FCC's triennial review will be included in our 2002 Form 10-K. Additionally, as discussed in "Data/Broadband" below, broadband regulations have also caused us to reduce capital expenditures.

This continuing difficult and uncertain regulatory environment combined with the continued weakness in the U.S. economy and increasing local competition from multiple wireline and wireless providers in various markets presents significant challenges for our business.

Expected Growth Areas

We expect the wireline segment to remain the most significant portion of our business and have also discussed trends affecting this segment (see "Wireline Segment

Results"). Over the next few years we expect an increasing percentage of our revenues to come from two areas within the wireline segment, data/broadband and interLATA long-distance, and from our wireless segment. Whether, or the extent to which, growth in these areas will offset declines in other areas of our business is not known.

Data/Broadband In October 1999, we announced plans to upgrade our network to make broadband services available to approximately 80% of our U.S. wireline customers over the four years through 2003 (Project Pronto). Due to the weakening U.S. economy and an adverse regulatory environment, in October 2001 we announced a scale-back in our broadband deployment plans. Specifically, burdensome FCC and state commission regulations regarding our DSL network have added significantly to our costs and delayed our ability to earn a profit on DSL service. Our cable modem competitors are not subject to these regulations. This adverse regulatory environment was the primary reason we decided to slow the build-out of our broadband network. We expect to spend significantly less on capital expenditures due to this scale-back. Despite this scale-back, our DSL lines continue to grow and were approximately 2,199,000 at December 31, 2002, compared to 1,333,000 at the end of 2001 and we expect to achieve profitability in early 2004. Our addressable broadband market included 66% of our consumer and small-business locations at December 31, 2002.

The FCC began its review of the rules for the provision of domestic broadband services by incumbent local carriers or their affiliates in December 2001. The FCC is reviewing broadband services offered over cable, satellite and wireless platforms in addition to traditional wireline offerings. In February 2002, the FCC issued a notice of proposed rulemaking tentatively concluding that wireline broadband access services are information services rather than telecommunications services, which would result in less regulation. The FCC also is considering eliminating the requirement that wireline telephone companies provide the transmission component of broadband internet access services as stand-alone telecommunications services and whether it should adopt an alternative broadband access requirement for ISPs. Cable operators have no obligation to provide third-party ISPs access to their broadband networks at this time, although the FCC has initiated a proceeding to consider the issue.

In December 2002, the FCC ruled that advanced services, such as DSL, provided through one of our advanced services subsidiaries, are not subject to tariff regulations and cost study requirements. However, we are still required to retain cost data and offer our retail advanced services for resale at a discount. This ruling should allow us to respond more quickly to offerings by unregulated competitors. The FCC is expected to complete its broadband review in mid-2003 and the effect of the review on our results of operations and financial position cannot be determined at this time.

Long-Distance We offer landline interLATA (traditional) long-distance services to customers in selected areas outside our wireline subsidiaries' operating areas. Further, we offer interLATA wireline long-distance services to customers

in Texas, Kansas, Oklahoma, Arkansas, Missouri and Connecticut. The FCC approved our application to provide wireline interLATA long-distance for California customers effective in December 2002, and we launched service in California under the SBC brand on December 30, 2002. Additionally, in December 2002, the Public Utilities Commission of Nevada approved our Nevada wireline subsidiary's application to enter the interLATA long-distance market in Nevada and we filed for approval from the FCC on January 14, 2003. In January 2003, the Michigan Public Service Commission approved our Michigan wireline subsidiary's application to enter the interLATA long-distance market in Michigan and we filed for approval from the FCC on January 16, 2003. The FCC must issue its decision within 90 days of our filings, if it deems our filings complete. Finally, we continue to seek long-distance approval in our remaining in-region states and have filed applications with state commissions in Illinois, Indiana, Ohio and Wisconsin.

Wireless Cingular, our wireless joint venture with BellSouth, began operations in October 2000 (see Note 6). Cingular serves approximately 21,925,000 wireless cellular and PCS subscribers and is the second-largest provider of mobile wireless voice and data communications services in the United States, based on the number of wireless subscribers. Cingular has access to licenses to provide cellular or PCS wireless communications services covering an aggregate population of potential subscribers, referred to as "POPs", of approximately 231 million, or approximately 81% of the U.S. population, including 45 of the 50 largest U.S. metropolitan areas.

Cingular's priorities for 2003 include promotion of the Cingular brand to expand its customer base profitably; continued realization of revenue and cost synergies offered by its formation; increasing the capacity, speed and functionality of its network through the continued rollout of wireless data services by overlaying Global System for Mobile Communications (GSM) voice, which is the standard digital cellular phone technology used in Europe and other countries around the world, and General Packet Radio Service (GPRS) high-speed data technology over its existing networks; development and promotion of advanced wireless data applications over multiple communications devices; and continued expansion of its existing footprint and network capacity by obtaining access to additional spectrum, primarily through spectrum exchanges, purchases, mergers or acquisitions.

In January 2002, Cingular and AT&T Wireless Services Inc. (AT&T Wireless) agreed to form a joint venture to build out a GSM/GPRS/Enhanced Data Rates for Global Evolution (EDGE) network along a number of major highways in order to reduce incollect roaming expenses paid to other carriers when customers travel on those highways. Cingular and AT&T Wireless will buy roaming services from the venture. Cingular is obligated to contribute licenses and cash or other assets having a value equal to the cash or assets contributed by AT&T Wireless. Cingular expects this venture to be formed in the first half of 2003 and does not expect its investment to exceed \$85.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Dollars in millions except per share amounts

In December 2002, Cingular announced an agreement with AT&T Wireless to transfer to AT&T Cingular's license and operations in Kauai, Hawaii and wireless licenses in Alabama, Idaho, Oklahoma, Mississippi and Washington. In return, Cingular will receive wireless licenses in Alabama, Arkansas, Georgia, Kentucky, Louisiana, Mississippi, Tennessee and Texas. Cingular expects this transaction to close in the first half of 2003.

In May 2001, Cingular and VoiceStream Wireless, now T-Mobile, exchanged spectrum. Through this action, Cingular gained access to a license covering over 20 million additional POPs in the northeast. In November 2001, Cingular entered into a joint infrastructure venture with T-Mobile to allow the companies to share network infrastructures in California, Nevada and the New York City metropolitan area markets. Cingular and T-Mobile's existing networks in these markets were contributed to the venture. Cingular and T-Mobile will have access to the venture's network infrastructure and will buy network services from it, while each retaining ownership and control of its own licenses. Funding for capital investments and cash operating expenses of the venture will generally be made by Cingular and T-Mobile on a pro rata basis based on network traffic. Cingular will independently market services to customers using its own brand name and utilizing its own sales, marketing, billing and customer care operations.

Cingular also invested in Salmon PCS (Salmon), a participant in a December 2000/January 2001 FCC auction of wireless spectrum licenses. Salmon was awarded 45 licenses at the conclusion of this process. Thirty-four additional licenses Salmon won at the auction were wireless licenses of carriers in bankruptcy reclaimed by the FCC and were not issued pending completion of United States Supreme Court (Supreme Court) proceedings concerning the validity of the FCC's spectrum reclamation process. In April 2002, the FCC returned 85% of the auction deposits pertaining to the auction of licenses held by the companies in bankruptcy. Salmon received a refund of approximately \$358 and prepaid the same amount on the principal of their note payable to Cingular. In December 2002, the FCC approved the dismissal of Salmon's applications to buy the licenses, released it from any further obligations and returned its remaining \$63 deposit. In January 2003, the Supreme Court ruled that the FCC's actions in reclaiming licenses from carriers in bankruptcy violated bankruptcy law and invalidated the auction of these licenses. This decision does not affect the 45 licenses previously awarded to Salmon.

As noted above in the discussion of Cingular's 2003 priorities, although data revenues are not currently a significant portion of Cingular's total revenues, Cingular plans to accelerate the development of this growing business. By the end of 2002, Cingular had launched GSM/GPRS technology over approximately half of its POPs including in New York, California, Connecticut, Kentucky and Ohio. Cingular also plans to upgrade its network to third generation (3G) wireless data technology by introducing EDGE and began testing EDGE in late 2002. EDGE technology is Cingular's choice for a 3G wireless communications standard that will allow customers to

access the Internet from their wireless devices at higher speeds than even GPRS. Cingular expects the GSM/GPRS/EDGE network overlay to be fully complete by the end of 2004. During 2003, Cingular expects to spend approximately \$1,200 for overlaying its existing network with GSM voice, GPRS data and EDGE data technology.

REGULATORY DEVELOPMENTS

Wireline

Federal Regulation A summary of significant 2002 federal regulatory developments follows.

Long-Distance Under the Telecom Act, before being permitted to offer interLATA wireline long-distance service in any state within the 12-state region encompassed by the regulated operating areas of Southwestern Bell Texas Holdings Inc. (SWBell), Pacific Bell Telephone Company (PacBell), Ameritech and Nevada Bell (these areas with the addition of Southern New England Telecommunications Corp.'s (SNET) area are referred to as our 13-state area), we are required to apply for and obtain state-specific approval from the FCC. The FCC's approval, which involves FCC consultation with the United States Department of Justice and the appropriate state commission, requires favorable determinations that our wireline subsidiaries have entered into interconnection agreement(s) that satisfy a 14-point "competitive checklist" or, alternatively, the subsidiaries have a statement of terms and conditions effective in that state under which they offer the "competitive checklist" items. The FCC also must make favorable public interest determinations in connection with each application. The status of our interLATA wireline long-distance approvals is discussed above under "Expected Growth Areas".

Unbundled Network Elements In May 2002, the Supreme Court upheld FCC UNE pricing rules that govern the rates incumbent local exchange carriers, such as our wireline subsidiaries, charge competitors for interconnection and for leasing portions of the incumbents' telephone networks. The FCC rules require incumbents to charge competitors rates based on hypothetical costs that competitors would incur for building a new, most efficient telephone network rather than on incumbents' actual historical, incurred costs. The Supreme Court also upheld FCC rules requiring incumbents to perform the functions necessary to combine unbundled network elements for competitors when they are unable to perform the combination themselves or unaware that they need to combine elements to provide a telecommunications service.

In May 2002, the United States Court of Appeals for the District of Columbia (D.C. Court of Appeals) vacated the FCC's UNE Remand and Line Sharing Orders. The UNE Remand Order expanded the definition of UNEs and required incumbents, such as our wireline subsidiaries, to lease a variety of UNEs to competitors. As discussed in "Operating Environment Overview" above, this Order required incumbents to provide below-cost UNE-P. It also required incumbents to provide below-cost combinations, in lieu of charging market rates for data transport services, to competitors that provide a "significant amount" of

local service. Such combinations of unbundled loops and transport elements are often referred to as "enhanced extended links" (EELs). (Data transport services are a component of our wireline revenues.) The Line Sharing Order required incumbents to share the high-frequency portion of local telephone lines with competitors so that competitors could offer DSL services on a national basis. The D.C. Court of Appeals overturned the FCC's unbundling and line sharing rules. Specifically, the Court found that the FCC failed to properly apply the statutory "necessary and impair" requirement in deciding which UNEs needed to be unbundled and did not consider the costs of overly expansive unbundling requirements and the relevance of competition for broadband services from cable and, to a lesser extent, satellite offerings. The D.C. Court of Appeals delayed the effective date of its decision until February 20, 2003. In October 2002, the D.C. Court of Appeals upheld the FCC's decision that limited the availability of EELs to competitors providing a significant amount of local service.

As noted above in "Operating Environment Overview", in February 2003, the FCC completed its triennial review of UNE regulations, the text of which was not available at the deadline for printing this Annual Report. This FCC review reopened the question of which network elements must be made available on an unbundled basis under the Telecom Act and revisited the unbundling decisions made in the overturned UNE Remand and Line Sharing Orders discussed in the preceding paragraph. The FCC was also expected to address other pending issues relating to UNEs, including under what circumstances we must provide below-cost UNE-Ps and EELs to competitors.

We voluntarily committed to maintain our affected line sharing offerings at least until February 15, 2003. During this period, we indicated a willingness to work with our wholesale customers to develop mutually acceptable market-based offerings and prices related to line sharing. These actions were intended to provide certainty to our wholesale line sharing customers while preserving our rights. Our long-term success requires a balanced regulatory environment that encourages investment and results in sustainable, facilities-based competition, including the elimination of rules that require us to sell our lines and related services to competitors below our cost.

Reciprocal Compensation fees are billed to our wireline subsidiaries by competitors for the termination of certain local exchange traffic to competitors' customers and vice versa. In April 2001, the FCC ruled that calls to ISPs are interstate access and not subject to reciprocal compensation. These calls are primarily from our customers to third-party ISPs. However, instead of immediately eliminating all reciprocal compensation fees charged to us and other wireline providers, the FCC established an optional transition plan for local exchange carriers. To date, none of our wireline subsidiaries have opted into the transition plan as they continue to negotiate their own contractual rates with competitors. Appeals of reciprocal compensation decisions are currently pending before various federal and state courts. We have fully accrued expenses for fees

sought by competitors for the termination of internet traffic to ISPs.

In April 2001, the FCC also launched a broad examination of all forms of inter-carrier compensation as well as proposed to eliminate all reciprocal compensation when the three-year transition plan expires. This proceeding may involve numerous rounds of comments before a final decision is reached, and a ruling is not expected for several years.

Collocation Equipment The Telecom Act requires incumbent local exchange carriers, such as our wireline subsidiaries, to co-locate in the incumbents' buildings, competitors' switching equipment necessary for inter-connection or access to the incumbents' networks. We provide physical space and facilities for the equipment and services to connect to our network, which we call collocation services. At December 31, 2002, we had \$520 recorded in Property, Plant and Equipment - Net, representing equipment we use to provide these collocation services. Due to industry consolidation and bankruptcies, the number of overall competitors requesting access to our buildings has decreased; consequently, the use of our collocation services has decreased. Because of this decreased utilization, we do not expect our future revenues from these collocation services will be sufficient to recover the cost of this equipment; however, we may seek further recovery from the state utility commissions. The amount of further recovery, if any, cannot be determined at this time.

Coalition for Affordable Local and Long Distance Service (CALLS) In September 2001, the United States Court of Appeals for the Fifth Circuit (5th Circuit) ruled on appeal of the FCC's May 2000 CALLS order restructuring federal price cap regulation. Although the 5th Circuit upheld the order in most key respects, it reversed and remanded to the FCC two specific aspects of the order.

- The 5th Circuit held that the FCC failed to sufficiently justify an incremental \$650 in universal service funding and remanded to the FCC for further explanation of the amount; and
- held that the FCC failed to show a rational basis for how it derived the 6.5% transitional mechanism, i.e., the productivity factor used to reduce access rates until a targeted average rate is achieved, and remanded to the FCC for an explanation of how the percentage was derived.

The current universal service fund amount and transitional mechanism will remain in effect pending FCC response. The effect of any future FCC order on our results of operations and financial position cannot be determined at this time.

Ameritech Merger In association with its approval of the October 1999 Ameritech merger, the FCC set specific performance and reporting requirements and enforcement provisions that mandate approximately \$2,000 in potential payments through June 2004 if certain goals are not met. Associated with these conditions, we incurred approximately \$20, \$94 and \$355 in 2002, 2001 and 2000 in additional expenses, including payments for failing to meet certain performance measurements, specifically, the "Opening Local